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The Political Economy of Fiscal Policy in EMU

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Abstract

This paper treats low inflation in EMU as a collective action problem for Ecofin. The SGP and more broadly the BEPG, operating against a background of the ECB and wage-setting, are the instruments for this. The ECB delegates sanctioning to the member-states while preserving the authority to set interest rates. Labour relations systems in different countries pursue disinflationary wage settlements. The BEPG (including the SGP) therefore have to be understood as a critical element in a signalling game between the ECB, Ecofin and the wage-setting systems.

Keywords: *EMU, fiscal policy, Stability and Growth Pact*

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1. Introduction

Since the summer of 2002, the Stability and Growth Pact, the institutional framework for fiscal policy in EMU which is supposed to accompany the new monetary arrangements, has come under severe fire. Keynesian economists, finance ministers and lately even Commission president Romano Prodi have pointed out the problems with it. Even usually more conservative observers such as the Financial Times and the Economist have argued against the current Stability and Growth Pact and called for a revision.

It is crucial for such a debate on the future of the Stability and Growth Pact to be built on a more subtle understanding than the currently prevailing one. In this paper, which presents a preliminary analysis of the institutions involved in fiscal policy-making in EMU and their operation over the three years since EMU, I make two substantive points. The first is that a proper understanding of fiscal policy-making in EMU, requires locating it within its broader institutional context. This involves analysing how the configuration of the Broad Economic Policy Guidelines (BEPG) and the Stability and Growth Pact (SGP) directly influences government policy in member-states; it also requires understanding how wage-setters and the ECB (may) influence that fiscal policy configuration. Such a contextualised understanding of fiscal policy offers a better understanding of how the SGP actually operates, and why it may produce counterintuitive outcomes.

The second point is that an analysis of the three years of the BEPG and the SGP in action suggests that EMU operates in a macro-economic policy framework that is very different from many of its conventional interpretations. Within a low-inflation context provided by the wage bargainers (see Hancké 2002; Hancké & Soskice 2003), the parties in the BEPG seem to accept fiscal discretion as long as it is neutral with regard to inflation or contributes to disinflation. Paradoxically, therefore, by reintroducing fiscal policy as an adjustment mechanism, this policy framework obtains a much more Keynesian character than commonly assumed.

The paper is organised as follows. The next section sets the question by discussing the operation of the fiscal policy institutions in EMU. Section 3 develops a simple model that can make sense of some of the counterintuitive findings reported in section 2. The fourth section empirically compares the two instances of the BEPG and the SGP in action: the incident over the Irish budget in 2001 and the discussion of the German budget in 2002. The final section concludes by integrating the material and presenting a series of questions which follow from this discussion.

2. Fiscal policy-making institutions in EMU

As has been argued by several authors, the advent of EMU has profoundly changed the logic of macro-economic decision-making in the EMU (and EU) member-states. Centralised monetary policy in the ECB was linked to a decentralised fiscal policy in which individual countries retain the authority for taxation and expenditure. In order to deal with the co-ordination problems that might ensue as a result of this asymmetry in policy-making, the EMU member-states agreed to a model of policy co-ordination --the OMC-- through the SGP, which applied solely to EMU member-states, and the EU-wide BEPG (Maher and Hodson 2001),

The political history of the SGP is not without importance and explains why it appears, on paper at least, as a stringent monetarist disciplining device. In part to buy acquiescence from the Bundesbank to go ahead with EMU, and in part to alleviate German fears of southern-European lack of fiscal prudence, the SGP imposed strict fiscal discipline by turning the logic of the Maastricht criteria into an unwritten economic constitution for EMU. The SGP is part of the Treaty of Amsterdam (1997) and therefore a binding document for all EMU member-states.

The most important components of the SGP are that governments accept a 3% budget deficit maximum --except under very specific circumstances of negative growth (the excessive deficit procedure), and a balanced budget over the cycle and within the foreseeable future. The institutional vehicle that assures compliance with these provisions is Ecofin (in collaboration with the Commission), which organises what is called 'mutual surveillance'.

The excessive deficit procedure. When the budget deficit of an EMU member-state reaches 3%, a series of automatic procedures are set in motion: the Commission reports on the member-state's transgression, Ecofin evaluates the Commission's report and issues a warning. If no corrective action is taken, the member-state is provisionally fined (up to 0.5% of its GDP), a fine it foregoes if the deficit is not in line by the second year after the initial warning.

Balanced budgets. The SGP stipulates that government budgets have to be balanced both over the cycle and within foreseeable future. The year initially proposed for balanced budgets was 2004, but as a result of the low growth period in the EU since 2000, appears to be negotiable. The idea underlying this policy is that a balanced budget offers states more freedom for a fiscal stimulus when growth slows without breaching the SGP.

Mutual surveillance. Formally, the SGP is part of the EMU framework only, and therefore in principle only applies the member-states in monetary union. However, its operation is embedded more broadly in the BEPG (combining to form the OMC), As a result, EU member-states that are not members of EMU, such as the UK, Sweden, and Denmark, participate in the implementation of the SGP in exchange for peer-monitoring their economies in Ecofin --the Council of EU Finance and Economics Ministers. Ecofin thus becomes the institutional vehicle for the implementation of the BEPG in general and the SGP in particular.

By the end of 2002, it had become increasingly obvious that the SGP was operating along very different lines than those envisioned by its architects. Most importantly, perhaps, in the only instance in which the excessive deficit procedure could (or should) have been invoked --in February 2002, when the German deficit came very close to the 3% deficit ceiling-- the letter of the SGP, which called for a low-level reprimand, was not followed. In contrast, when Ireland ran a budget surplus a year earlier, the Council of Ministers voiced a strongly worded concern that Ireland was adopting economic policies at odds with the broader agreed-upon goals in the EU/EMU.

Lest we ignore the issues at stake: the SGP is a binding international treaty with the force of law; how, then, should we understand this profound divergence between the letter of the SGP and its actual operation? What does this suggest about the SGP in particular and the broader macro-economic policy framework of EMU in general? While one group of authors deplores the lax interpretation of the SGP, and argues for a more stringent adherence to its rules (see Beetsma & Uhlig 1999; Gros 2002), another group argues that it is overly restrictive and that a redefinition of the SGP is necessary in order for the EU to avoid being stuck in a deflationary system within which individual member-states are bearing the costs of adjustment (Canzoneri & Diba 2000; De Grauwe 2000; Schelkle 2002), The first group therefore sees both episodes as essentially punishable transgressions of the SGP, while the second argues that what happened to the Irish and the German budget plans demonstrates that the SGP is moot as a treaty.

However, because of their normative character, neither of these arguments shed much light on how to understand the actual operation of the SGP: while these two positions come to radically different conclusions about the desirable future, they seem to agree on two elements. The first is that the SGP is best treated in perfect isolation from the rest of the macro-economic policy framework within EMU; the second is that the letter of the SGP is the optimal starting point for any political-economic analysis.

Such a literal reading of the SGP seems to miss two points with important consequences. The SGP and the broader BEPG are embedded in a series of other institutions for economic policy-making at the EU/EMU level --the Commission, the Council of Ministers (Ecofin), and the ECB. The interaction between those different institutions, against a background of low inflationary pressures provided by the wage-bargaining systems (Hancké 2002), has produced a profoundly different policy consensus from the one expressed in the SGP (see Eichengreen 1998 for an early attempt to understand EMU as an integrated policy framework),

In its simplest version, the argument goes like this: as long as member-states contribute to the goal of low aggregate EMU-wide inflation, either by pursuing explicitly disinflationary policies (frequently the result of wage moderation in domestic settlements) or at least by not adopting policies that incite inflation, the SGP is interpreted very liberally, both by Ecofin and by the ECB. In the case of emerging inflationary pressures within member-states (especially the larger ones), however, which might have effects on the EMU aggregate inflation rate, the response to such a threat is in the first instance initiated by the Council of Ministers itself. Ecofin could thus be regarded as a delegated monitor for the ECB. Note that such policies in principle support the ECB's stance without prejudging them. Generalised disinflationary policies allow the ECB to bracket out inflation and adjust monetary policy accordingly. If, however, the ECB judges Ecofin's decision to be insufficient, the central bank can always react independently by raising interest rates.

However, since even member-states that behave properly will face the negative consequences of an ECB reaction (Gatti & Van Wijnbergen 2002), Ecofin as a collective body faces very strong incentives to assure low inflation in EMU as a whole, but can be considerably more lenient on fiscal policy that does not endanger the ECB's inflation target. This suggests that the SGP is neither the orthodox restrictive monetarist tool that its proponents take it to be, nor the economic equivalent of a nuclear option that has no practical relevance because everybody shies away from deploying it, but *de facto* a soft Keynesian framework, which may leave considerable discretion to governments as long as budgets do not evolve significantly out of line with the EMU average and low inflation is maintained.[1]

This argument will be developed in two steps. The next section develops the idea that fiscal policy under EMU is a collective action problem. Section 4 compares the decisions regarding the fiscal stances of Ireland in February 2001 and Germany in 2002 to show that policy considerations very different from the monetarist interpretation of the SGP were at the basis of the decisions reached by the Council of Ministers: the Irish budget potentially endangered the low inflation target of the ECB, while the German budget plans did not, and the reaction by Ecofin was therefore very different in the two cases, reflecting the different implications of fiscal policy in the two countries.

3. Fiscal policy-making as a collective action problem

In order to understand the current macro-economic policy regime in EMU, of which fiscal policy is a constituent part, the most appropriate starting point is the relation between ECB and Ecofin. Monetary stability, expressed as low inflation, can be seen as a public good, of which all EMU members benefit (in the form of low interest rates), For public goods to exist at all, a framework of sanctions and incentives is required that imposes individual compliance with the collective goals.

Within the EMU set-up, such sanctions do not exist. The EMU member-states have no tools to assure that the policies of individual member-states are congruent with a low collective inflation goal. In fact, the only mechanism that exists within EMU is the ECB's interest

[1] Note that we are not arguing that the SGP is an optimal instrument. Many of the concerns voiced by more radical Keynesian authors and by some policy-makers, such as measuring deficits in structural rather than cyclical terms, applying a Golden rule, or even focusing on the EMU-aggregate fiscal situation, are very valid indeed. Our argument is that in its actual operation, the current BEPG already embodies embryonic versions of such proposals.

rate policy, but since the central bank's decisions affect all member states without distinguishing between those with 'good' (i.e. disinflationary) and those with 'bad' (i.e. inflationary) behaviour (Gatti & Van Wijnbergen 2002), it is a very blunt instrument, that the well-behaving member-states would rather not see in operation, since it imposes asymmetric costs on them.

This brings us to the SGP, and more broadly the BEPG. Precisely because it is impossible for the EMU member-states to punish inflationary policies in individual member-states, Ecofin resorts to the BEPG as a means of keeping individual member-states in check. Defections that endanger the public good, i.e. inflationary fiscal policies by individual member-states, are sanctioned by the group as a whole, while non-inflationary fiscal policies are --with the silent support of the ECB-- left in relative peace. The SGP/BEPG framework is therefore not just a narrow instrument to control overly expansive fiscal policies, but also an indirect sanctioning mechanism for Ecofin in its derived goal of containing inflation.

Ecofin can thus be seen as simultaneously a delegated monitor for the ECB and its first line of defence. With the use of the BEPG (including the SGP), the Council pre-empts a virulent ECB reaction if individual member-states adopt inflationary policies, thus safeguarding the collective good of low inflation and avoiding a situation in which the (majority of) governments toeing the disinflation line are punished when one or a few of them misbehave. Conversely, fiscal policies that do not endanger the ECB's low inflation target are left untouched, even if they break the formal provisions of the SGP --a stance that appeared to receive the tacit approval of the ECB.[2]

It is not hard to see --as we will develop in more detail in the next section-- that the debate within Ecofin surrounding the Irish budget in February 2001 is an obvious case of the first of these situations. In a period of rapid growth and growing inflationary pressures, the Irish government ran a budget surplus, and therefore decided to lower taxes. Yet by doing so, the Irish government's policies raised inflationary dangers for the EMU as a whole --both directly (although the small size of the Irish economy in EMU would have structurally contained those dangers) and indirectly by setting a bad example for others --and the Council reacted accordingly.

The argument also helps understand the discussion surrounding Germany's budget deficit in February 2002 and its paradoxical outcome. Precisely because the German fiscal position was backed up by a situation of low and falling inflation and a commitment to keep domestic inflation in line with the EMU aggregate inflation rate, the Council of Ministers concluded that a sanction, however symbolic, was premature and unnecessary --and the ECB concurred by not raising objections.

4. The SGP and the BEPG in action

Since the adoption of the Euro in 1999, the institutional framework of fiscal policy-making has been put to the test twice: once in February 2001, when the Irish budget surplus was severely criticised by the Council of Ministers, and again in February 2002, when Commissioner Solbes requested a sanction for Germany and Portugal (a so-called 'blue letter', the equivalent of a yellow card in football) because their budgets were approaching the 3%

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[2] In late 2002 and early 2003, the ECB seemed to have changed its line on Ecofin, and began to make loud public noises about the need to stick to the SGP. In all fairness I have to admit that it is unclear at this moment whether this confirms or disconfirms the argument in this paper: the ECB might have feared that Ecofin was unable to do its job and therefore sent out a signal to Ecofin members, which is perfectly consistent with my argument; alternatively, this might herald a profound shift in ECB attitude from benign neglect to active involvement in fiscal policy. If the latter is the case, the ECB --and with it EMU as a whole-- might be walking on very thin ice: not only is it unclear if a central bank should or can be a Stackelberg leader in macroeconomic policy, it is also questionable if the ECB should respond to issues outside its strict mandate and thereby obfuscate its reaction function (Allsopp 2002).

budget deficit ceiling defined in the SGP. In both instances the ultimate outcome of the process ran counter to the expectations of many. Despite a budget surplus (and therefore hardly prone to imprudent fiscal excesses), Ireland was fiercely reprimanded by the Council, while the German deficit in 2001 was condoned and in fact used as an argument to rethink the details of the SGP.

This section will compare these two instances of the SGP and the BEPG in action. It will demonstrate that the counterintuitive outcomes in both cases take on a different shape if we assume an unspoken quasi-Keynesian consensus among the EMU/EU member-states and between them and the ECB, which allows for more discretion in fiscal policy than both the SGP and the BEPG appear to grant member-states. This discretion, however, is contingent upon the capacity of Ecofin to safeguarding low inflation. The comparison of these two cases thus illustrates the argument made above that inflationary fiscal or wage policies are punished by Ecofin while policies that do not contribute to rising inflation are not. The structure of the section is straightforward. After a short review of events in the two cases, a longer section will discuss the relevant points of comparison.

Ireland 2001. Prior to 2001, Irish economic growth had outpaced all its European counterparts for several years. The effect of this period of rapid growth was that by the end of 2000, high wage growth and the housing boom had led to an inflation level far above that of EMU as a whole: 4.2% as opposed to 1.2% for EMU (OECD 2002), In 2001, and backed up by a budget surplus, the government proposed lowering taxes for that year.

Since these budget plans were seen as over-expansionary and therefore contributing to higher inflation in Ireland, especially in the absence of moderate wage growth levels to offset the fiscal expansion, Ecofin in response issued a recommendation to the Irish in February to revise its budget for 2001-2003 (the first step in the procedure of the BEPG), Even though technically the Irish were not in breach of the SGP, their fiscal policies contradicted the wider co-ordinated macro-economic policy framework of the BEPG, and as a result, Ecofin had little choice but to formally sanction the Irish budgetary stance, which was directly responsible for inflationary pressures.[3] While developments in a small economy such as Ireland probably have very little direct impact on the aggregate inflation rate, the Irish policy stance was dangerous because, if it passed unchecked, it sent the wrong signal to other, larger EMU member-states, such as France and Spain, who might find themselves in a similar position after a few years of rapid growth.

A comparison with developments in the Netherlands in 2001, when inflation jumped as the combined result of the oil and food demand shocks of 2000, a very tight labour market as a result of low unemployment, and a substantial tax break, is instructive. Ecofin did not issue a warning to the Dutch (despite the obvious inflationary dangers), because labour unions and government had reorganised to immediately react by keeping wage growth low: in response to the high inflation rate, real wages were scheduled to fall in the 2001-2002 wage round. Inflation indeed fell from an annualised 4.6% in March 2001 to 3.6% in March 2002, and was forecast to fall to 2.9% in 2002 and 2.3% in 2003 --against a background of resuming high growth and stable low unemployment (Economist 4 may 2002),

In sum, rather than a counterintuitive and misguided reaction, Ecofin's sanctioning of the Irish budget in 2001 made perfect sense when it is regarded as a direct attack on the inflationary policy stance of the Irish government. With its budget, the Irish potentially endangered the aggregate low-inflation environment of EMU, thus increasing the risk of a reaction by the ECB that might have endangered macro-economic conditions in the entire EMU. Sanctioning the Irish stance was the only instrument at Ecofin's disposal to pre-empt such a reaction.

[3] The fact that Irish fiscal policy itself was directly responsible for inflationary pressures made the application of the BEPG relatively easy. One might wonder if Ecofin would have issued a warning if potentially rising inflation had been a result of excessive wage settlements instead of fiscal policy.

Germany 2002. The situation was very different in Germany in February 2002. After several years of below EMU-average growth, economic growth almost stalled in 2001. The result was that the German budget showed a deficit close to the 3% limit imposed by the SGP in both 2001 and 2002: 2.6% in 2001 and a forecast of 2.7% for 2002. Several developments combined to make the episode particularly poignant. In large measure as a result of low growth as well, unemployment started to rise again for the first time in four years, and since the Red-Green coalition had used the evolution of unemployment as a yardstick measure its performance, the government was left with little choice but to run a deficit in order to avoid a further rise in unemployment. An important element was operating in the background: 2002 is an election year, and Chancellor Schröder faced stiffer competition than expected from the CDU-CSU main opposition party, who challenged its macro-economic policy record.[4]

Relying on a strict interpretation of the SGP, the Commission therefore proposed to Ecofin in February 2002 to issue a formal reprimand to the German government. While there was a small group of orthodox hard-liners among the member-states (including Belgium and The Netherlands, countries who in the past or at the time were far from examples of fiscal rectitude), a large enough minority, led by Germany and the UK, managed to block a formal reprimand. (Especially the UK's position was interesting: Gordon Brown strongly implied that the SGP would have to be rethought if the UK joined EMU in order to take account more clearly of structural instead of cyclical deficits, and to assess budgets over the cycle rather than at any particular point in time.)

Ultimately, Ecofin did not sanction Germany and the Council simply avoided the issue, by asking the German government to balance its budget by 2004.[5] The Commission's reaction was --predictably-- one of disappointment and barely disguised anger: as the self-imposed guardian of the SGP, it felt sidetracked and betrayed by the Ecofin decision, and invoked stark images of the demise of the Euro as a result of the loss of credibility of the SGP. The ECB's reaction was considerably more surprising: instead of issuing a sharp condemnation of Ecofin's decision, the ECB was silent on the matter. This is all the more surprising since the ECB can be seen as the agent of financial markets in EMU (the principal), and in a monetarist world such a lax interpretation of the SGP could indeed undermine EMU's credibility.

What can we learn from this comparison of the two instances of the SGP *cum* BEPG in operation? First of all, the letter of the SGP does not offer a helpful tool for interpreting these two cases. Ireland was not in breach of any of the provisions of the SGP, and Germany was on the verge of a breach. However, Ecofin paradoxically singled out the Irish stance and failed to condemn the German policies. Secondly, the ECB stood out because of its silence on the issue: it did not even issue a press release in response to the breach of the SGP in the case of the German budget in 2002. If the credibility of the SGP had really been at stake, a reaction from the ECB --any reaction-- could have been expected.

Excessive formalism is therefore not a good guide for interpretation. A proper understanding of these two paradoxical outcomes requires a recalibration of the framework for interpreting fiscal policy in EMU. In the case of the Irish budget, a reaction imposed itself to prevent a sharp retaliation by the ECB with effects beyond the Irish. The reaction predictably came via the framework offered by the BEPG, the only tool available to EMU member-states

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[4] The deficit had relatively few discretionary elements, and basically reflected the fall in government revenue. However, in principle the government had the possibility to run a smaller deficit, by rapidly raising taxes (as the Kohl government had done after German unification and Italy had done in the run-up to EMU), but it chose not to. This suggests that, despite the low level of discretionary spending, fiscal policy was indeed used as an anti-cyclical measure.

[5] More egoistic considerations by members of Ecofin might have informed the decision as well: Germany is the most important economy in EMU and the main trading partner of almost all other EMU member-states. As a result of these trade links, falling demand in Germany therefore would have had rapid and direct effects on growth in the other member-states, and allowing fiscal reflation in Germany assured that growth in other member-states did not suffer. Thanks to Dermot Hodson and Waltraud Schelkle for insisting on this point.

to sanction defections. In the German case, in contrast, the situation was very different: the Schröder government's policies did not endanger inflation, and no ECB reaction was therefore necessary. Consequently, Ecofin did not act.

The crucial difference between Ireland and Germany was not its relation to the (letter of the) SGP, but their potential and real effects on inflation. Ireland's policy was both inflationary and pro-cyclical. If it had not been kept in check, the entire EMU might have suffered as a result of a potential reaction by the ECB. Even though the Irish economy was too small in itself to weigh heavily in the aggregate EMU inflation rate, it set a bad example, since one defection could have led to more. (The comparison with the situation in The Netherlands in 2001/02 demonstrated this point: for cyclical reasons the country also experienced higher than EMU-aggregate inflation, but government and wage-setters immediately acted to contain it, and Ecofin did not issue a reprimand.) Ecofin thus punished the Irish budget on the basis of its inflationary potential, not on its own merits.

Germany's policy, in contrast, was anti-cyclical and did not pose threats to low inflation. It therefore did not put the credibility of the SGP and EMU at risk, but isolated any risks that might emerge. Even within EMU, German fiscal policy can still be singled out by capital markets, by raising the risk premium on German debt and not on others. Furthermore, since German policies were not leading to rising inflationary pressures (inflation fell, in fact, from 2.9% in 2001 to 1.6% in 2002, with a further fall forecast for 2003 and 2004), there was no danger of the ECB reacting with a hike in interest rates, since its inflation target was not endangered as a result of the German policies, and consequently Ecofin could adopt a more lenient stance toward Germany.

Thus, since both cases had very different implications for inflation in EMU as a whole, the other EMU/EU member-states responded with different (apparently counterintuitive) policies, while the ECB stood by as an acquiescing accomplice. As long as inflationary pressures are kept in check therefore, both the ECB and Ecofin are (within a broad and cyclically contingent interpretation of fiscal discipline) relatively neutral with regard to the fiscal policy stance of individual member-states. When, however, inflationary dangers rise, Ecofin rapidly responds by sanctioning the member-state, in order to avoid a reaction from the part of the ECB (which would be interpreted by many as an over-reaction with dire consequences for both individual member-states and EMU as a whole), Since Ecofin cannot directly attack inflationary policies of member-states, it does so with the only weapon at its disposal: the sanctioning procedures under the BEPG.

This comparison between these two episodes suggests that the policy architecture around the SGP and the BEPG (the OMC) therefore has to be seen as a policy framework embedded in a broader set of institutions: the ECB's possible reaction set (which, while keeping an eye on broad macro-economic developments in EMU, disproportionately favours low inflation), on the one hand, and the wage bargaining system, which leads to disinflationary wage settlements, on the other.

This suggests that the triangle between Ecofin, the ECB and the wage bargaining systems is the crucial framework for understanding macro-economic policies in EMU. Through wage moderation, wage setters can directly contribute to low inflation (and they do so in most EMU member-states), thus keeping medium-term inflation on the ECB's target, and Ecofin offers some sort of arbitration between these two other actors and the governments.

5. Conclusion: Rethinking the SGP

In EMU, low inflation is a collective action problem for Ecofin to resolve. The SGP and more broadly the BEPG are the instruments for this; however, they operate against a background of two further institutions. The first one is the ECB who 'delegates' sanctioning --while preserving the (ultimately very coarse) weapon of interest rates-- to the member-states. The second element is provided by the labour relations systems in different countries that actively pursue disinflationary wage settlements. The BEPG (including the SGP) therefore have to be understood as a critical element in a signalling game between the ECB, Ecofin and the wage-setting systems.

Within such a redefined institutional framework, the SGP is already reconstructed: instead of a rigid deflationary monetarist tool it has become in part a more flexible and pragmatic macro-economic policy instrument for the whole of EMU. As long as structural inflation risks are low (which, all other things being equal, means that wage bargaining is disinflationary), both the ECB and Ecofin appear to tacitly accept a Keynesian fiscal policy over the cycle that leaves discretion to governments.

Despite appearances to the contrary --and which has led, both among academic economists and policy-makers, to loudly voiced concerns over the future of EMU-- such a set-up provides a win-win situation for governments (represented, in the average, by Ecofin) and the ECB. Against a background of low inflationary risks, Ecofin seems to allow for (see Germany in 2002) and sometimes strongly recommends (see Ireland in 2001) fiscal policy to accommodate existing (and probably persisting) differences in the business cycles of different EMU member-states, and as a collective actor has adopted a policy of 'benign neglect' to small violations of the letter of the SGP (as long as the spirit is honoured), The ECB, in turn, for whom inflation containment is the single most important goal in its reaction function, benefits from the arrangement because disinflationary wage and fiscal policies obviously make it easier to reach that goal without a loss in output or rising unemployment, or --wishful thinking, perhaps, but worth considering none the less-- would make more growth-oriented accommodating monetary policies possible.

Such a framework is nothing less than a pragmatic Keynesian-inspired policy consensus between the macro-economic agents in EMU. Unions deliver low wage inflation, the ECB the conditions for growth, and governments use fiscal policy to smoothen asymmetric fluctuations in the national business cycle. Critiques of the restrictive nature of the SGP certainly are correct, but it is hard to think of this reconfigured policy-making framework as simply a deflationary disciplining device.

This brings us back to the issue at the beginning of the paper. A pessimistic interpretation of EMU is that it produces the worst of all possible worlds: an autistic central bank ('hearing but not listening'), a masochistic fiscal policy (the strict interpretation of the SGP), and a competitive wage policy in which unions in one country undercut wages in another. These outcomes are certainly possible in the current set-up and are present already in embryonic form. The other one, which was advocated here, is equally possible: the central bank sticks to a strict inflation target, but responds to (responsible) policies by wage-setters and governments (both institutions that at least in principle democratically represent their citizens and members) instead of trying to lead them into policy-making. The current debates on the SGP are important because they offer an opportunity to make explicit such a division of labour between central bank and other economic agents.

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